

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Campbell Analyst: Gloria McConnell Bill Number: AB 987

Related Bills: AB 343 (1995/96) Telephone: 845-4336 Amended Date: APTBA

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: PIT Rates/Percentage of Federal

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____ STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY OF BILL

This bill would change the method of computing the California personal income tax (PIT) for taxpayers who do not have any income that is taxed by another state or country. For these taxpayers, the PIT would be a yet-to-be-determined percentage of the taxpayer's federal tax liability, prior to the application of any federal tax credits, reduced by any credits allowed under California's PIT law.

SUMMARY OF AMENDMENT

This amendment removes the previous language in the bill that declared the legislative intent to simplify the tax laws and inserts the above summarized provisions.

EFFECTIVE DATE

This bill, as a tax levy, would be effective immediately and operative for tax years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 343 (1996/95) proposed that for calendar year 1995 only, individuals who were not engaged in business, farm or rental activities or did not have items treated differently for federal or state tax purposes would compute their California income tax based on a percentage of their federal taxable income, but only if no federal income tax law changes were enacted for tax year 1995.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald Goldberg

12/28/99

PROGRAM HISTORY/BACKGROUND

Federal legislation typically is not enacted until late in the year, however the changes may be applicable beginning in that year. Typically, the federal legislative year ends after the California legislative year. So, at the time California law is enacted for a given year, federal laws for that same year may still be undecided. Using federal law to compute California taxes before California has had an opportunity to review and enact it is considered "prospective conformity." It has been Legislative Counsel's opinion that prospective conformity would be an unconstitutional delegation of state legislative powers to the federal government.

The enactment of this tax method, which is frequently called "coupling," previously has been rejected in the California Legislature and through ballot initiatives.

SPECIFIC FINDINGS

California's PIT law is largely patterned upon federal law. To compute California income tax, taxpayers begin by copying their federal adjusted gross income (AGI) to their California income tax return. However, because state tax law combines unique state provisions with selected federal provisions that sometimes are modified, adjustments to federal AGI and other federal numbers are required for state purposes. The PIT rate ranges from 1% to 9.3%, whereas the federal individual income tax rate ranges from 15% to 39.6%. Married couples in California are taxed at the same rate as though they are two single individuals with the same income, whereas under federal law they are taxed at a higher rate than if they were two single individuals (referred to as the "marriage penalty"). Nonresidents and part-year residents are taxed only on income from California sources, but the rate of tax is determined by referencing income from all sources and then using a ratio to eliminate the benefit of the graduated rate structure.

Other areas that reflect significant differences between federal and state law that would be affected by this bill are:

- Treatment of depreciation, net operating losses (NOLs), including disaster NOLs, and determining basis in computing gains and losses;
- Exempt interest income and lottery winnings taxable under federal law but not state law;
- Social Security, worker's compensation or unemployment benefits taxable under federal law and exempt under state law;
- Treatment of personal and dependent exemptions as deductions under federal law and credits under state law;
- Treatment of married couples as previously discussed;
- Treatment of state income taxes paid;
- Special state tax deductions intended to provide economic incentives and support social policies.

This bill would change the method for calculating the personal income tax for taxpayers who do not have any income that is taxed by another state or country. The PIT for these taxpayers would be a yet-to-be-determined percentage of the taxpayer's federal tax liability, prior to the application of any federal tax credits for the same taxable year, reduced by any credits allowed under California's PIT law.

Policy Considerations

- Automatic conformity to federal laws enacted after California's Legislature recesses may be an unconstitutional delegation to Congress of California's legislative powers.
- A "marriage penalty" would be created because California would be adopting the federal married-couple standard deduction, which is instrumental in creating the federal "marriage penalty."
- Certain special state deductions and exclusions that target specific taxpayer groups or encourage specific taxpayer behavior (i.e., disaster NOL deduction, crime hot-line reward exclusion and rideshare exclusion) would be eliminated.
- Federal law allows taxpayers who itemize a deduction for state income taxes paid. It may not be appropriate to allow this deduction for state tax purposes, and this bill does not provide for adjustments to the federal tax to compensate for this deduction.
- California PIT currently is computed by making the following adjustments to federal adjusted gross income, which would not be made under this bill: state tax refunds; unemployment compensation; social security benefits; railroad retirement benefits; capital gains and losses; IRA distributions; pension and annuities; and moving expense reimbursements.
- This bill would violate California's Constitution since it would indirectly tax bond interest on United States government issued securities that is taxable under federal law but is exempt from California tax. Further, this bill would violate federal law that requires nondiscriminatory taxation of federal interest.
- California's current filing requirement thresholds would not apply to taxpayers using the coupling method. Instead, the federal filing requirement thresholds would be used, and as such, any California residents or nonresidents with California source income who are required to file a federal tax return would be required to file a California tax return.
- California's tax law is more progressive than federal law, with higher filing thresholds. In fact, legislation was recently enacted to adjust the filing thresholds for the dependent exemption and senior exemption credits to reduce return filings. This bill could subject low-income Californians to income tax who currently do not pay California tax or have a filing requirement.

FTB staff in March 1991 prepared a report which discusses the impact of coupling the state PIT tax to federal tax. This report is available on request.

Implementation Considerations

Considering the magnitude of the policy issues, this analysis assumes the bill will experience significant amendments as it moves through the legislative process. Therefore, a detailed implementation plan has not been developed, and the full impact on the department's programs and operations has not been determined. However, it is known that to administer this bill would require significant planning and restructuring to maintain efficiencies without jeopardizing or disrupting collection of tax revenue. It is also known that under this bill, the FTB would continue its current computer program and organization processing structure to accommodate those with income taxed by other states or countries. This may cause noncompliance and confusion given that there would be two tax methods (and tax tables) in existence. As of June 30, 1999, staff processed approximately 500,000 1998 income tax returns of non-residents and part-year residents and 83,000 returns where the individuals claimed the credit for taxes paid to other states. These are returns in which the taxpayer's income is subject to tax in other states. All other individuals filed approximately 12.1 million 1998-income tax returns. The full impact of this bill will be determined as the bill moves through the legislative process.

Staff will work with the author on this bill as the bill is developed.

FISCAL IMPACT

Departmental Costs

FTB does not yet know the departmental costs that would be associated with this bill. However, it is known that some of the issues that will need to be resolved by staff in developing the costs will include:

- How many new taxpayers would be filing under coupling,
- How many additional tax forms would need to be distributed,
- Whether electronic and telefiling could be implemented for the first year filing under coupling (tax year 2000 returns due which may be filed as early as January 1, 2001),
- The extent of taxpayer confusion resulting in questions and errors,
- How many taxpayers would question the new form and/or the two filing methods (assuming FTB were to maintain the current access rate for its telephone service center); and
- How many taxpayers would correspond or make errors because of the new form, using the wrong booklet instructions and therefore using wrong method/tax table?

Tax Revenue Estimate

The revenue estimate is unknown and cannot be determined until the percentage of federal tax is determined.

BOARD POSITION

Pending.